

Distressed Investor Considerations in E&P Oil and Gas Restructurings

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This Practice Note provides guidance and advice to investors in exploration and production (E&P) company restructurings. This Note specifically addresses restructurings of oil and gas E&P companies and the strategies that distressed investors may use to protect their investments.

The US oil and gas industry has had several dramatic ups and downs since 2014, including historically higher numbers of Chapter 11 bankruptcy filings of E&P debtors during some periods, particularly in 2016 and 2020. Overall, from 2014 through 2021, the US oil and gas industry suffered substantial distress, grappling at times with severely depressed oil prices and burdensome debt levels. In 2022, however, at times there were positive developments for E&P companies as higher oil and gas prices (spurred on by, among other factors, tightening supply) led to record profits for some E&P companies. Although the COVID-19 pandemic has subsided, in its aftermath, the current climate for the energy sector continues to be beset with substantial uncertainties regarding global supply and demand, stemming from significant geopolitical and global economy issues and circumstances.

Historical Volatility in Energy Sector

Global oil and gas prices began trending lower in the summer of 2014 because of a confluence of factors, including:

- Slowing global economic growth.
- Excess gas and oil supply.
- Declining demand for oil and gas.

Oil prices continued their downward slide in 2015, causing the energy sector to account for approximately 30 percent of rated corporate debt defaults as of September 2015 (see Chuck Carroll & John Yozzo, *If You Thought the Energy Sector Was Distressed...*, Am. Bankr. Inst. J. at 12 (September 2015)). As one illustrative measure, the price of WTI crude

oil went below \$30 a barrel in early 2016, compared to oil prices at or near \$100 in the first half of 2014.

The majority of oil and gas exploration and production (E&P) companies receive financing by issuing debt, often in the form of junior liens and unsecured bonds. Because of depressed oil and gas prices these E&P companies were not able to meet their debt obligations and took steps to restructure, including filing for Chapter 11. As a result, energy bankruptcy filings were on the rise during this time period (peaking in 2016) and their Chapter 11 cases moved at a fast pace due to the Bankruptcy Code's time limitations for filing a plan of reorganization and making a determination to reject executory contracts and unexpired leases.

Oil prices rallied in 2017 and the frequent storyline is that the US energy sector was rebounding by mid to late 2017 through much of 2018 (for example, WTI crude oil was nearly \$75 per barrel in mid-2018). However, significant challenges continued in the oil and gas industry with the price of WTI crude oil unexpectedly dipping below \$50 per barrel in December 2018. Despite a rebound in early 2019, the price in mid-2019 was approximately \$50 per barrel. Compared with recent preceding years, however, oil prices traded within relatively narrow price ranges during 2019.

Various factors continued to have an adverse effect on oil prices overall, including:

- Rising US crude stockpiles.
- Fear of faltering demand (including due to worsening US and China trade relations).
- Continued negative perception of oil and gas as an environmental concern.

- The [emergence](#) of battery electric vehicles (BEVs) as a viable alternative.
- Decarbonization policies that included mandates and subsidies for renewable energy.
- The 2020 Saudi Arabia/Russia oil price war.

This Note addresses some of the many legal, business, and operational concerns that investors in E&P companies must consider both in and out-of-court and provides guidance and strategies to help investors protect their investments.

The Unprecedented COVID-19 Pandemic

During 2020 and 2021, the COVID-19 pandemic brought about a historic drop in energy demand, crashing global oil prices, and slower investment in new oil and gas development.

In early 2020, on a national and international level, the COVID-19 pandemic and its adverse economic and business effects worsened and accelerated. Oil prices initially plummeted (at one point turning negative for the first time on record) because of the significant reduction in domestic and global economic activity resulting from COVID-19. The pandemic triggered an unprecedented shock in the oil industry as demand for oil cratered when governments around the world shuttered non-essential businesses, issued stay-at-home mandates, and restricted travel. Other adverse factors were also in play during this period, for example, the Saudi Arabia-Russia oil price war that began in March 2020 when the two nations failed to reach a consensus on oil production levels. After January 2020, oil prices fell from approximately \$63 per barrel to a one day drop into negative territory closing at -\$37 per barrel in mid-April 2020.

By the summer of 2020, as nations were emerging from early lockdowns and the Organization of Petroleum Exporting Countries (OPEC) agreed to major cuts in crude oil production, oil prices rebounded to approximately \$40 per barrel. By the end of 2020, optimism about the planned rollout of multiple COVID-19 vaccines buoyed the markets. For example, WTI crude ended 2020 at a price near \$50 per barrel.

In 2021, oil prices steadily and strongly increased, reaching seven-year highs in February 2022 (near \$90 per barrel), as increasing COVID-19 vaccination rates, loosening pandemic-related restrictions, and a growing economy resulted in global petroleum demand rising faster than supply. The slower increase in production was largely attributable to crude oil production cuts by OPEC

and other countries that started in late 2020 when OPEC, Russia, and other countries had announced in December 2020 that they intended to continue to limit production increases throughout 2021.

In this context, E&P companies generally focused less on long-term investments in capital expenditure and more on paying down debt, repurchasing shares, and increasing dividends to improve their short-term financial positions and improve shareholder returns.

Post-Pandemic Period: Oil, Gas, and Power Markets

As the COVID-19 pandemic subsided, much of the world faced energy shortages and oil and gas price increases. Various factors are at play, including:

- The rapid post-pandemic economic rebound that outpaced energy supply.
- The uncertainty and turmoil resulting from the [2022 Russian invasion of Ukraine](#).
- Global refining capacity shortfalls caused by labor and accident issues.
- Overall inflation that put upward pressure on prices independent of supply constraints.

In 2022, oil prices hit their highest levels in more than a decade, the price of natural gas reached record highs, and the oil and gas industry earned record profits. Despite a growing list of nations agreeing to phase out coal use, power generation from coal-fired plants reached all-time highs, largely driven by Asia.

While the outlook for the oil and gas industry for 2023 is uncertain, many analysts predict continued tight supply, suggesting oil prices higher than current levels, stemming from the combination of lower Russian oil supply and OPEC supply cuts. One major supply uncertainty for the oil market continues to be driven by the Russian supply hold up, particularly as certain European Union bans and restrictions against Russian exports become effective in early 2023.

In early 2023, Russian supply of oil exceeded what analysts expected because India, China, and a handful of other smaller buyers increased their purchases of Russian crude oil because of available steep discounts. The evolving Russia and Ukraine war is also significant factor for the oil markets; while a de-escalation may not lead to the return of pre-war oil supply levels, it may likely remove a substantial amount of risk from the market. OPEC has largely ignored calls from the US and other key consumers

to more aggressively increase oil supply amid supply concerns and higher prices.

Despite substantial revenues generated by high oil and gas prices in 2022, US companies have generally hesitated in producing to their full capacity. The mentality of many US producers appears to have changed significantly from producing as much as possible to focusing on shareholder returns, reducing debt, and therefore, showing discipline when it comes to capital spending and development. Supply chain issues, labor shortages, and rising costs have also played a role in the modest supply growth by US producers. Some analysts predict continued moderation in capital spending and production growth.

Apart from supply issue uncertainties, there are also significant demand uncertainties, largely relating to China's demand as that nation's COVID problems and zero-COVID policy play out. Some analysts predict global demand to modestly increase overall to, but to be weaker than had been originally thought, as high energy prices and a negative macro outlook for the US, Europe, and Asia weigh down oil demand. Particularly given the uncertainties of geopolitics and the direction of the global economy, oil and gas prices may be highly volatile in 2023.

Because of these various global circumstances and domestic factors, E&P companies have experienced a volatile ride for several years, including the unprecedented COVID-19 pandemic which continues to have residual effects. Therefore, to the extent oil and gas companies look for ways to restructure in the current climate, it continues to be important for investors to quickly and efficiently identify issues and develop solutions to maximize value on account of their investments.

E&P Companies

The oil and gas E&P sector is capital intensive. E&P companies require significant amounts of capital to finance their operations (including developing and drilling new oilfields, extracting and processing any oil and gas recovered, and transporting the oil and gas to where it is needed). To finance their operations, E&P companies often use third-party financing (see Reserve Based Financing).

Most E&P companies, however, are small to mid-sized companies (typically referred to as independents) that only own upstream assets. According to the Independent Petroleum Producers of America, there are about 9,000 independents in the US. These companies:

- Develop approximately 91% of the wells in the US.
- Produce approximately 83% of the US's oil.
- Produce approximately 90% of the US's natural gas.

Response of E&P Companies To Declining Oil and Gas Prices and Other Challenges

In response to previous periods of declining oil and gas prices and other industry challenges, E&P companies experiencing operational and financial distress have responded at times in different ways, including:

- Scaling back planned exploration activity.
- Reducing operating expenses.
- Reducing long-term investment in capital expenditures.
- Relying on third-party service providers and suppliers to carry out certain crucial activities, including hiring contractors for:
 - equipment and tools;
 - drilling;
 - engineering services;
 - maintenance and repair services;
 - technology and information solutions;
 - safety and environmental compliance services; and
 - inspection and testing services.
- Restructuring out-of-court.
- Filing for Chapter 11.

Creating Solutions for Investors in the Challenging Climate for Oil and Gas Companies

Investors in E&P companies must be mindful of a multitude of financial, operational, and legal concerns and often work strategically with the company to preserve value by:

- Forcing an operational improvement.
- Providing an accommodation on a defaulted loan.
- Deleveraging the balance sheet.

These solutions can be achieved in an out-of-court restructuring (see Out-of-Court Restructuring Considerations) or a Chapter 11 filing (see Chapter 11 Process: Areas of Uncertainty and Complexity).

Out-of-Court Restructuring Considerations

E&P companies may use out-of-court restructurings to recapitalize or reorganize the capital structure outside of a bankruptcy proceeding, either in a restructuring of the company's debt or equity, or both. The purpose of this workout transaction is to:

- Preserve the going concern value of the business and maintain a viable company by rearranging its capital structure to reduce the aggregate amount of debt.
- Stretch out debt maturities or modify restrictive covenants or other burdensome agreements.

Many different methods can be used to implement an out-of-court restructuring, including:

- Refinancing, which retires the existing debt by issuing new debt or securities, often accomplished with private equity investors.
- Issuance of junior lien debt to new investors (junior in priority to existing notes or other lenders), providing the company with additional liquidity.
- Asset sales, including sales of the company's E&P interests and stakes in ancillary projects.
- Exchange offers, including exchanges of existing notes for new notes and stock.

However, the availability, prospects, and net benefits of these alternatives may be limited in many situations. An analysis based on Securities and Exchange Commission (SEC) filings, company press releases, management presentations, and other related sources, identified only a relatively small amount of successful out-of-court transactions, primarily debt or equity exchanges, involving E&P companies.

While an asset sale is also another way to expeditiously raise funding, the net benefits of a sale may be limited because there is often a significant difference between the price a company is willing to sell its assets for and the price that a buyer is willing to pay. Therefore, bankruptcy may be a more likely alternative for some distressed E&P companies.

For more information generally on out-of-court restructurings and their purpose, see [Practice Note, Out-of-Court Restructurings: Overview](#).

Possible Accommodations from Lenders

Although low oil and gas prices adversely affected many borrowers, some lenders have been willing to work with

their borrowers to help them manage the low price environment. This willingness is often motivated by:

- The lenders' need to deploy capital.
- Competition from other lenders.
- The understanding that forcing a company into a default or bankruptcy may not be the most pragmatic choice (see [Chapter 11 Process: Areas of Uncertainty and Complexity](#)).

Significantly limiting a borrower's borrowing capacity may also be counterproductive because it prevents E&P companies from developing wells that are needed for company growth and to repay the loans.

As a result, a distressed E&P company may try to obtain various accommodations from its investors or lenders to avoid a Chapter 11 filing and help with an out-of-court restructuring. These accommodations include:

- Granting an extension of debt maturity timetables.
- Permitting additional debt.
- Reducing interest expenses.
- Suspending or loosening certain financial covenants.
- Offering improved terms or new or additional security on existing indebtedness.

Traditional senior bank lenders may focus on avoiding default and be receptive to allowing the borrower additional time if it does not impair the lender's collateral value. Secondary debt purchasers and junior lenders may be more focused on time adjusted returns on their investments and may be interested in creating ownership opportunities at low valuations.

However, investors and companies may both face certain difficulties in obtaining these accommodations. Investors and lenders must understand the loan covenants and the additional financing and refinancing they permit. Amendments to existing credit facilities generally require 100% or substantial majority lender consent and payment of significant lender fees. In many cases, lenders may not be willing to consider potential material modifications or the company may not have the available cash to pay the required lender fees. This can prevent a successful out-of-court restructuring. But, in the context of a Chapter 11 case, provided that certain requirements are met, an E&P company can cram down a plan that modifies existing debt over the objections of a lender under section 1129(b) of the Bankruptcy Code (see [Practice Note, Chapter 11 Process: Overview: Confirmation of a Plan: Cramdown Plans](#)).

Reserve Based Financing

Most E&P companies do not have enough liquidity to finance the exploration, drilling, and other costs with their own money. The companies with sufficient liquidity to finance their operations are generally large, vertically integrated, multinational oil companies (typically referred to as majors or mid-majors) that own downstream, midstream, and upstream assets. Many E&P companies typically instead rely on reserve based credit facilities for their working capital needs and to fund their exploration and development projects. A reserve based loan is a type of asset-based loan where the amount the E&P company is entitled to borrow under the loan is based on the value of and is secured by its proved oil and gas reserves, as determined from time to time (see [Practice Note, Reserve Based Loans: Issues and Considerations](#)).

Proved oil reserves are quantities of oil that can be estimated by analyzing geological and engineering data to be commercially recoverable from a specific date forward from known reservoirs. Unproved reserves are too speculative to form the basis for reserve based lending. To determine the amount of reserves, lenders review reserve reports that the borrower provides. These reports set out estimates of the reserves determined internally by the borrower or an independent petroleum engineer. Because of the changing nature of oil and gas reserves, reserve based facilities typically require scheduled redeterminations and special redeterminations of the borrowing base.

In times of steep price declines, most E&P companies' availability for additional borrowings under their reserved based credit facility are reduced as the value of proven reserves shrinks. There may also be a borrowing base deficiency that may trigger a requirement that the borrower:

- Pledge additional collateral, which it may not have.
- Pay down the debt, causing a liquidity crisis.

To the disadvantage of the borrower, the value of oil and gas reserves is far more subjective and variable than the value of traditional asset-based credit facility inventory, such as consumer goods and raw material. Lenders under a reserve based facility also typically exert more control over the process that determines the borrowing base.

Lenders may respond to the financial difficulties facing E&P companies under reserved base facilities by either:

- Aggressively reducing borrowing bases knowing, however, that this further tightens borrower liquidity.

- Waiving or suspending financial covenant violations and being more flexible in trying to ride out a period of depressed energy prices.

These steps are similar to what a lender does in a time of stable or rising energy prices, provided the lender examines whether there are operational or other issues causing the liquidity difficulties if the price of energy is stable or rising.

Involuntary and Premature Bankruptcy Filings

Both involuntary bankruptcy filings and prematurely filed Chapter 11 cases place investors at risk of being able to fully protect their interests because of the lack of preparation and the absence of agreement between the debtor and its creditors.

Risks for Investors in an Involuntary Bankruptcy Filing

A risk for some distressed E&P companies is that their creditors may force a premature insolvency proceeding by filing an involuntary petition (see [Practice Note, The Involuntary Bankruptcy Process](#)). While E&P debtors face substantial challenges when creditors file an involuntary proceeding, investors also have to avoid significant risks to protect their interests.

Commencing an involuntary proceeding may adversely affect creditors and equity security holders by:

- Thwarting ongoing negotiations between a debtor and its secured creditors.
- Preventing any consensual restructuring or solution that may have been possible if not for the bankruptcy filing.

Investors should consider refraining from filing an involuntary bankruptcy petition because:

- The potential disadvantages of bankruptcy generally, including its substantial costs, delays in recovery, and potential adverse effect on the going concern value of the debtor's business.
- Petitioning creditors can face significant liability for costs and attorneys' fees if the court dismisses the petition, as well as punitive damages and damages proximately caused by the filing if the court finds the petition was filed in bad faith (see [Bad Faith Filing](#)).
- Once creditors file the petition, they cannot withdraw it, even if the debtor agrees to the withdrawal. Dismissal

requires notice to all creditors and an opportunity for a hearing.

- Creditors may have preference exposure, which can be avoided if the debtor stays out of bankruptcy (see [Practice Note, Preferential Transfers: Overview and Strategies for Lenders and Other Creditors](#)).
- The filing of the petition triggers the automatic stay, which prohibits creditors from taking any other action to collect on their debts (see [The Automatic Stay](#)).
- Defeating the debtor's challenges to the petition can often be difficult and expensive.

Despite the risks, some E&P companies have been forced into bankruptcy by their creditors. For example:

- In the case of *Northstar Offshore Group, LLC*, creditors filed an involuntary Chapter 11 petition against the debtor, an oil and gas exploration and production company (*In re Northstar Offshore Grp., LLC*, No. 16-34028 (Bankr. S.D. Tex. Aug. 12, 2016)). The debtor agreed to convert the involuntary proceeding to a voluntary case by filing a voluntary Chapter 11 petition.
- In May 2019, petitioning creditors filed an involuntary Chapter 11 case against White Star Petroleum LLC in the Bankruptcy Court for the Western District of Oklahoma. White Star shortly after filed its own Chapter 11 voluntary petition in Delaware Bankruptcy Court. These cases were later consolidated to proceedings before the Oklahoma Bankruptcy Court in early July 2019 (Case No. 19-12521-JDL). In September 2019, petitioning creditors placed Rovig Minerals, an oil and gas drilling operator, into an involuntary Chapter 11 proceedings (*In re Rovig Minerals, Inc., et al.*, No. 19-51133 (Bankr. W.D. La. Sept. 25, 2019)). The Chapter 11 cases were amicably converted to voluntary proceedings and a Chapter 11 trustee was appointed.

Risks for Investors in a Premature Voluntary Filing

While an E&P company may not be prepared to adequately respond to an involuntary filing, it may be equally damaging for an E&P company to file a Chapter 11 case without sufficient planning and prepetition negotiation with creditors. However, it is possible that an E&P company may choose to prematurely file for bankruptcy protection under various situations, including:

- To gain leverage over uncooperative lenders or investors.
- To prevent an emergency situation, such as the pending or potential foreclosure of a substantial asset.

Unless a bankruptcy filing was pre-negotiated with creditors, investors may believe that any Chapter 11 filing is premature and unwarranted. A premature voluntary filing may harm investors by:

- Frustrating a favorable out-of-court restructuring or other solution.
- Commencing an expensive, lengthy bankruptcy process that has risks and uncertainties.

Potential Actions for Investors Against a Premature Voluntary Case

In the absence of specific provisions in a company's corporate charter or loan documents that restrict a bankruptcy filing without proper lender consent, investors have few options for recourse against the company and its board of directors (see [Practice Note, The Involuntary Bankruptcy Process: Dismissal of an Involuntary Bankruptcy Case](#)). However, there are potential causes of action that investors may consider bringing to impede the bankruptcy case, including:

- Derivative Actions (see [Derivative Actions](#)).
- Bad Faith Filing (see [Bad Faith Filing](#)).

Derivative Actions

Aside from a challenge to the debtor's valuation (see [Practice Note, Postpetition Interest, Fees, Costs, and Charges in Bankruptcy: Valuation of Collateral](#)) or a challenge to the E&P company's proposed insolvency, a potential remedy for investors when dealing with a premature bankruptcy is to file a derivative action against the company's board of directors alleging breach of fiduciary duty.

Once the E&P company files a bankruptcy petition, derivative claims for breach of fiduciary duty become property of the bankruptcy estate and have to be prosecuted by either:

- The debtor-in-possession or Chapter 11 trustee, if one was appointed.
- A special party, such as a creditors' committee, which receives court authority and standing to bring the action on behalf of the estate.

In the absence of the debtor's or trustee's agreement to allow the special party to pursue the action, it is often difficult to obtain standing from the bankruptcy court to bring a derivative action during the Chapter 11 case (see *Unsecured Creditors Comm. v. Noyes (In re STN Enterprises, Inc.)*, 779 F. 2d 901, 905 (2d Cir. 1985)

(creditors' committee can initiate actions on behalf of estate where, among other things, debtor unjustifiably refuses to bring suit and claim for relief is colorable)).

Companies in the energy sector use different forms of business entities (aside from the common corporate organizational entity) that may be subject to different standards of liability and court review. For example, Delaware limited partnerships are contractually permitted to expand, restrict, or eliminate fiduciary duties in their partnership agreements. This permits the partnership agreement to explicitly waive the fiduciary duties of the general partner or the limited partners (Del. Code Ann. tit. 6, § 17-1101(d) (fiduciary duties "may be expanded or restricted or eliminated by provisions in the partnership agreement")). Therefore, the viability of an investor's cause of action for a premature bankruptcy filing against an E&P debtor that is a Delaware limited partnership depends on, among other factors, the applicable provisions of the operative governance documents.

Investors must also be aware that it is typically a challenging argument to assert that a board of directors (of any form of organization) violated its fiduciary duties unless the board:

- Patently shirked its responsibilities and cursorily directed a bankruptcy filing without meaningful input from the company's insolvency counsel and other advisors.
- Cannot articulate any reasonable financial, business, or operational need for bankruptcy protection.

These are both unlikely occurrences in the case of a mid to large E&P company with generally competent management and advisors.

Bad Faith Filing

Investors may be able to attack a premature bankruptcy filing by alleging that the Chapter 11 case was filed in bad faith. While a bad faith analysis is highly dependent on the particular circumstances of each case, case law suggests that a motion to dismiss a case under section 1112 of the Bankruptcy Code may be successful when a relatively stable company with only speculative future difficulties files a Chapter 11 petition (see *In re SGL Carbon Corp.*, 200 F.3d 154 (3d Cir. 1999); *In re Liberate Techs.*, 314 B.R. 206 (Bankr. N.D. Cal. 2004); *In re Rent-A-Wreck of Am., Inc.*, 580 B.R. 364 (Bankr. D. Del. 2018)). Section 1112(b) of the Bankruptcy Code authorizes bankruptcy courts to dismiss a Chapter 11 case or convert it to one under Chapter 7, whichever is in the best interests of creditors and the estate, on a showing of cause.

Bankruptcy courts dismiss cases as bad faith filings when a solvent debtor, with a large amount of unrestricted cash sufficient to pay its liabilities, has an unsuccessful business, large losses, and several pending lawsuits. In one case, the court found that the alleged risk of potential continuing business losses in the future was not an adequate basis for filing (see *In re Integrated Telecom Express, Inc.*, 384 F.3d 108 (3d Cir. 2004); *In re Liberate Techs.*, 314 B.R. 206 (Bankr. N.D. Cal. 2004)).

However, case law exists supporting the opposing argument that, depending on the circumstances, potential, future difficulties may justify a Chapter 11 filing by a solvent, ostensibly stable company. Courts consider the financial difficulties of the entire interrelated corporate group. A debtor does not need to wait until its economic picture has irreparably deteriorated to file for Chapter 11 (see *In re Johns-Manville Corp.*, 36 B.R. 727 (Bankr. S.D. N.Y. 1984); *In re Roman Catholic Church of the Archdiocese of New Orleans*, 632 B.R. 593, 611 (Bankr. E.D. La. 2021) (debtor was not insolvent but was "experiencing financial distress" when it filed for bankruptcy)).

For example, *In re Mirant Corp.*, the court found that the debtor's case was filed in good faith for purposes of section 1112 where the debtor, despite being balance sheet solvent and able to pay its current debts, was part of a distressed corporate family of debtors and the other affiliates' filings may affect debtor (2005 WL 2148362 (Bankr. N.D. Tex. Jan. 26, 2005)). In *In re Gen. Growth Props., Inc.*, the court also determined that the Chapter 11 was not filed in bad faith despite the fact that some of the debtors' crucial debts were not maturing for some time (409 B.R. 43 (Bankr. S.D.N.Y. 2009)).

Challenges for Investors in Pursuing Actions for Premature Filings

While filing a derivative action or a motion to dismiss on grounds of bad faith are both potential acts investors may take to undo a premature bankruptcy filing, investors must be aware that they may also face two significant challenges that may be difficult to overcome:

- The business judgment rule (see Business Judgment Rule).
- Broad board exculpations (see Broad Exculpations).

Business Judgment Rule

A board's decision to authorize a bankruptcy filing is generally subject to the business judgment rule. Therefore, any action for breach of fiduciary duty has

to surmount the application of this highly deferential standard.

The business judgment rule under Delaware law provides that courts typically do not second guess a business decision made by a board or impose liability on its directors. There is a “presumption that in making a business decision, the directors of a corporation acted on an informed basis (i.e., with due care), in good faith and in the honest belief that the action taken was in the best interest of the company” (*In re Fruehauf Trailer Corp.*, 250 B.R. 168, 197 (D. Del. 2000)). Under this standard, the existence of any rational business purpose for the decision protects the decision from being disturbed.

Deficiencies in the directors’ decision-making process are actionable only if the directors’ actions are grossly negligent. A plaintiff has the burden of proof to demonstrate that the debtor’s directors were grossly negligent in violating the duty of care (see *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 749 (Del. Ch. 2005); *In re Citigroup Inc. S’holder Deriv. Litig.*, 964 A.2d 106, 124 (Del. Ch. 2009), citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). For example, in *Smith v. Van Gorkom*, the court found a company’s board to have been grossly negligent in determining whether to approve a merger, where the board heard a 20 minute oral presentation (which was largely an uninformed one) during a board meeting lasting a total of only two hours, with no documents for review, including the operative agreement, and no documented basis for the adequacy of the proposed price per share (488 A.2d 858 (Del. 1985)).

If plaintiffs are able to rebut the business judgment rule presumption, the burden then shifts to the debtor’s directors to demonstrate that the bankruptcy filing was “entirely fair” to the corporation and its stakeholders (see *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1287 (Del. 1989)). In this context, entirely fair means a fair price and fair dealing (see *Cinerama, Inc. v. Technicolor*, 663 A.2d 1156, 1162-63 (Del. 1995)). Therefore, the fairness standard requires the defendant to establish “to the court’s satisfaction that the transaction was the product of both fair dealing and fair price” (*Cinerama*, 663 A.2d at 1163). For a further discussion of fiduciary duties of directors and officers, see [Practice Notes, Fiduciary Duties of the Board of Directors and Crucial Steps to be Taken by the Board of Directors of Financially Troubled Companies](#).

Broad Exculpations

Apart from the business judgment standard, exculpatory provisions in the corporate charter may further shield a

debtor’s board of directors by exculpating or immunizing fiduciaries from responsibility or liability.

Section 102(b)(7) of Title 8 of the Delaware Code permits a Delaware corporation to include a provision in its certificate of incorporation that prospectively exculpates its directors from monetary liability for a breach of the duty of care alleged by the corporation or its shareholders, other than for:

- Conduct that constitutes a failure to act in good faith.
- Breach of the duty of loyalty.
- An act or omission of the director that involves intentional misconduct or a knowing violation of the law.

(See Del. Code Ann. tit. 8, § 102(b).)

Because most large Delaware corporations include exculpatory provisions in their corporate charters, “litigation concerning the duty of care is rare today” (see *In re Fedders N. Am., Inc.*, 405 B.R. 527, 540 (Bankr. D. Del. 2009); *Nelson v. Emerson*, 2008 WL 1961150 (Del. Ch. May 6, 2008)).

An exculpatory provision in the debtor’s charter may shield directors from potential claims that they violated their duty of care when filing the bankruptcy petition. Therefore, an E&P company’s board may be protected from liability in a fiduciary breach action if the board:

- Undertook a reasonable decision-making process.
- Can proffer reasonable financial and business justifications for the Chapter 11 filing.

Chapter 11 Process: Areas of Uncertainty and Complexity

Involuntary and premature bankruptcy filings are not the typical Chapter 11 path for an E&P company. The trend in E&P bankruptcies is instead for the companies to negotiate with secured lenders prepetition and enter into bankruptcy with a prepackaged or prenegotiated plan of reorganization (see [Practice Note, The Prepackaged Bankruptcy Strategy](#) and see [Chart, Timeline of a Prepackaged Bankruptcy Case](#)). In many instances, these plans involve a section 363 sale (see [Practice Note, Buying Assets in a Section 363 Sale: Overview](#) and [Chart, Timeline of a Section 363 Sale](#)) or a debt-for-equity swap, focused on a quick Chapter 11 exit (usually enforced in DIP financing, cash collateral, or sale orders involving tight milestones) with a plan for the prepetition secured lenders to own the business post-emergence. Some of the E&P bankruptcies are exceedingly accelerated. As an

extreme example, a natural gas operator, Arsenal Energy and its affiliates, took only 30 days from the time of the bankruptcy filing and submission of a prepackaged plan (under which approximately \$861 million of subordinated notes were converted to equity) until submitting motion for a final decree to close the Chapter 11 cases (*In re Arsenal Energy Holdings LLC*, Case No. 19-10226 (BLS) (Bankr. D. Del.)).

Depending on the E&P debtor's particular circumstances, the debtor may obtain significant benefits in an in-court insolvency proceeding. However, there are also specific areas of uncertainty in the law and other risks that may hinder the debtor's reorganization efforts and affect an investor's ability to protect its interest.

The Automatic Stay

On the petition date, the debtor and its operations are protected by imposition of the automatic stay under section 362 of the Bankruptcy Code which automatically stops substantially all acts and proceedings against the debtor and its property. It is a nationwide, possibly even worldwide, injunction barring almost all actions against the debtor and its property, including the exercise of remedies regarding collateral, enforcement of prepetition judgments, litigation, collection efforts, and acts to create, perfect, and enforce liens granted before the date the bankruptcy petition was filed (see [Practice Note, Automatic Stay: Overview](#)).

While the scope of the automatic stay is extremely broad, it is limited by judicial and statutory exceptions. Certain creditors, depending on their circumstances and the action at issue, may be exempt (or seek exemptions) from the automatic stay (see [Practice Note, Automatic Stay: Overview: Limitations and Exceptions](#)). Investors and lenders should be aware if they are able to use these exemptions to protect certain rights and interests in an E&P bankruptcy case, such as:

- Royalties (see [Royalties and Terminated Leases](#)).
- Recoupment (see [Recoupment](#)).
- Setoff (see [Setoffs](#)).

Royalties and Terminated Leases

Working interests, such as the exclusive right to explore, drill, and produce oil and gas from a fee simple mineral interest, are typically created by an oil and gas lease in which the E&P company receives the exclusive right to drill from the holder of the mineral interests. The holder of the mineral interests frequently retains a landowner royalty

interest and receives a share of the gross production from the mineral interest, free of development costs. The E&P company may then carve out various fractional interests from its working interest, including, for example, overriding royalty interests (ORRIs), net profits interests (NPIs), and production payments (PPs) (§ 101(42A), Bankruptcy Code). Each of these interests grants the holder the right to receive some portion of the production from the working interest.

The interests held by fractional interest holders generally are not property of the estate. Specifically, the safe harbor set out in section 541 of the Bankruptcy Code protects assignees of production payments or ORRIs from having their oil and gas interests included in the bankruptcy estate (§ 541(b)(4)(B), Bankruptcy Code). However, parties have challenged the debtor's or working interest owner's conveyance of a fractional interest and sought to **recharacterize** it as a disguised loan instead (see [Practice Note, Unsecured Creditor Perspectives In Energy Restructurings: Royalty Interest Holders](#)).

Some oil and gas leases also provide for the automatic termination of the lease if the royalties remain unpaid. When this happens, a royalty owner may seek relief from the automatic stay to exercise its rights under the contract or seek an order from the bankruptcy court that the applicable lease terminated. However, it is not necessary to obtain relief from the stay in cases where automatic termination provisions are enforceable under state law (for example, in Texas).

Royalty owners in some jurisdictions, like Texas, are protected by state statute as automatically perfected secured creditors without the filing of a financing statement (Tex. Bus. & Comm. Code § 9.343 ("An authenticated record giving the interest owner a right under real property law operates as a security agreement created under this chapter")). Other creditors of an E&P debtor may have statutory or contractual lien rights, for example, that arise under some joint operating agreements.

Exceptions to the automatic stay and a debtor's lien avoidance powers (§§ 362(b)(3) and 546(b), Bankruptcy Code) may also allow postpetition perfection of these rights under applicable non-bankruptcy law. In those instances, the beneficiary of a statutory lien may perfect its mechanic's or materialman's liens after the bankruptcy filing by, for example, recording a lien with the applicable county clerk and providing written notice to the property owner.

A discussion of the treatment of royalty interests by other states and US courts is beyond the scope of this Note.

Recoupment

Recoupment is an equitable defense that involves a determination of the net liability of parties holding claims against each other arising out of the same transaction. In bankruptcy, it allows a creditor to reduce its liability to the debtor by the amount of the debtor's obligation to the creditor and effectively treats the creditor's claim as secured to the extent of the amount it is entitled to recoup.

Recoupment rights are not affected by bankruptcy and the right of recoupment is not codified in the Bankruptcy Code. The majority of courts have held that recoupment is not subject to the automatic stay (see *Kosadnar v. Metro. Life Ins. Co. (In re Kosadnar)*, 157 F.3d 1011, 1014 (5th Cir. 1998); *Malinowski v. New York State Dep't of Labor (In re Malinowski)*, 156 F.3d 131, 133 (2d Cir. 1998)). These courts reason that the automatic stay is inapplicable because the funds subject to recoupment are not the debtor's property. They also apply a more restrictive test, which requires that both claims arise from a single integrated transaction where it is inequitable for the debtor to enjoy the benefits of the transaction without also meeting its obligations (see *Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 147 (2d Cir. 2002); *University Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1081 (3d Cir. 1992) and see [Practice Note, Creditors' Recoupment Rights in Bankruptcy: Claims Arise from the Same Transaction](#)).

Recoupment also arguably does not violate the automatic stay because it is an adjustment of liability on a debt, as opposed to a prohibited attempt to collect a debt (see [Practice Note, Automatic Stay: Overview: Prohibited Acts](#)).

However, a minority of courts disagree and have held that creditors wishing to exercise recoupment rights must first seek relief from the automatic stay (see *Burley v. Am. Gas & Oil Investors (In re Heafitz)*, 85 B.R. 274, 280 (Bankr. S.D.N.Y. 1988)). These courts reason that although the exact wording of the automatic stay provision does not refer to recoupments per se, they should still be subject to the automatic stay for the same reason that setoffs, which are expressly referred to in the provision, are subject to the automatic stay (§ 362(a)(7), Bankruptcy Code and see [Setoffs](#)).

For more information on recoupment in bankruptcy, see [Practice Note, Creditors' Recoupment Rights in Bankruptcy](#).

Setoffs

Setoff is the right of a creditor to reduce or cancel a debt it owes to the bankrupt debtor by the amount of its claim

against the debtor, provided that the offsetting debts are "mutual" (debts between the same parties standing in the same capacity) and both arose prepetition or postpetition (§ 362(a)(7), Bankruptcy Code). This allows a creditor to realize the full amount of its claim to the extent of the setoff. While setoff is closely related to the remedy of recoupment, there are important distinctions where setoff cannot be invoked. Conceptually, recoupment is a defense to a debtor's claim against the creditor (see [Recoupment](#)), while setoff involves mutual obligations owing between a creditor and a debtor. Unlike recoupment, the Bankruptcy Code expressly provided that a creditor needs relief from the stay to exercise rights of setoff.

A common setoff situation that arises in E&P cases involves triangular setoffs related to master netting agreements. Triangular setoff arises where parties A, B, and C agree that A may set off amounts owed by A to B against amounts owed to A by C (see [Practice Note, Creditors' Setoff Rights in Bankruptcy: Triangular Setoff](#)).

Bankruptcy courts typically do not permit triangular setoffs involving the creditor and more than one debtor. However, within the oil and gas industry, parties frequently negotiate for the right to offset debts owed to corporate affiliates with debts owed by different corporate affiliates in master netting agreements. Because of the lack of mutuality, courts are likely not to permit setoffs under master netting agreements and investors must be aware that the remedy is not available (see *In re Semcrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010); *Ciber Global, LLC v. SAP Am., Inc.*, 2021 WL 1141661, at *8 (E.D. Pa. Mar. 25, 2021) ("Although '[p]arties may freely contract for triangular setoff rights,' they may not do so 'in derogation of these mandates of the Bankruptcy Code'" (quoting *In re Orexigen Therapeutics, Inc.*, 990 F.3d 748, 755 (3d Cir. March 19, 2021)))).

For more information on setoffs in bankruptcy, see [Practice Note, Creditors' Setoff Rights in Bankruptcy](#).

503(b)(9) Claims

Unpaid sellers of goods are entitled to an administrative expense claim for the value of any goods received by the debtor within 20 days of bankruptcy, if sold to the debtor in the ordinary course of the debtor's business (§ 503(b)(9), Bankruptcy Code). This alternative remedy is available to sellers of goods whether or not they meet the requirements of reclamation or that entirely fail to assert their reclamation rights (§ 546(c)(2), Bankruptcy Code). The effect is to elevate the priority of a seller's claim for goods delivered within the 20-day period to a high-priority

administrative expense claim from a lower-priority general unsecured claim

Investors need to carefully consider and analyze this factor to understand the cost and impact of a bankruptcy filing. A large amount of section 503(b)(9) claims may consume much or most of any residual value that otherwise goes to unsecured noteholders and equity holders, each of which are all junior in priority to section 503(b)(9) claimants. Although not typical, a court may also order expedited payment of some or all valid section 503(b)(9) claims before plan confirmation. In that instance, the debtor's liquidity, funding, and reorganization prospects may be put at risk.

Exclusions from the Bankruptcy Estate: Farmout Agreements

Section 541(a) of the Bankruptcy Code defines the scope of property of the estate, which broadly includes all legal or equitable interests of the debtor in tangible and intangible property, wherever located and held by whatever party, as of the filing of a bankruptcy case, subject to limited exceptions. Exclusions from property of the estate are designed to protect parties in certain industries. One notable exclusion is the interests of the debtor in liquid or gaseous hydrocarbons transferred or agreed to be transferred under a farmout agreement and certain production payments from oil and gas producers (§§ 541(b)(4), 101(21A), 101(42A), Bankruptcy Code).

The Bankruptcy Code defines farmout agreements as agreements in which the owner of a right to drill, produce, or operate liquid and gaseous hydrocarbons on property (often referred to as the **farmor**) agrees to transfer or assign all or a part of that right to another party (**farmee**) and the other party, as consideration, agrees to perform the drilling, reworking, recompleting, testing, or similar or related operations to develop or produce liquid or gaseous hydrocarbons on the property (§ 101(21A), Bankruptcy Code). The impact of excluding farmout agreements as property of the estate may have a significant effect on the E&P debtor's bankruptcy efforts.

In a typical farmout arrangement in the oil and gas industry, the farmee drills a well and, when complete, earns a percentage of the acreage and additional rights. Title remains in the name of the farmor pending the farmee's completion of the contractual obligations. The Bankruptcy Code prevents a debtor-farmor from withholding from a non-debtor farmee an assignment of an interest in the property that has otherwise been earned by the farmee under the farmout agreement.

Therefore, if a nondebtor farmee holds a separate vested property interest, this interest is not subject to being stripped or modified in the bankruptcy case, while the contractual rights of a creditor with no vested property interest may be subject to impairment in the bankruptcy. Because the rights of the farmee are preserved, this also effectively reduces the scope and size of the estate assets, leaving less residual value available to pay creditors.

Executory Contract and Lease Rejection: Section 365

Under Section 365 of the Bankruptcy Code, a debtor's executory contracts and unexpired leases may be either assumed or rejected, subject to court approval. If an E&P company files for bankruptcy, it may be able to reject certain oil and gas leases if they are deemed to be executory contracts or unexpired leases. Section 365 may create risks for investors concerning the potential treatment of oil and gas leases and other contracts, such as joint operating agreements, in an E&P bankruptcy case.

Treatment of Oil and Gas Leases As Executory or Non-Executory Contracts

Case law is not settled on whether oil and gas leases are real property interests or executory contracts under the Bankruptcy Code. There are generally important differences between being an owner of a real property interest and a creditor under an executory contract. For example, a real property owner has a present right of possession, while a debtor may reject an executory contract leaving a nondebtor counterparty with only an unsecured damages claim.

Oil and gas leases are the asset base on which an E&P company is valued. During a period when oil prices decline, it is conceivable that an E&P company's valuable oil and gas leases are terminated before the bankruptcy filing because they may no longer be profitable for the nondebtor counterparties. For example, an oil and gas lease typically requires "production-in-paying quantities", which generally means that the oil and gas lease produces a profit (see *Andarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550 (Tex. 2002)).

Some landowners and mineral estate owners have used the production-in-paying-quantities requirement as a basis to terminate the lease when the lease is not profitable (see *In re Energytec Inc.*, 2009 WL 5101765 (Bankr. E.D. Tex. Dec. 17, 2009); *In re Nueces Petroleum Corp.*, 2007 WL 418889 (Bankr. S.D. Tex. Feb. 2, 2007); *T.W. Phillips Gas and Oil Co. v. Jedlicka*, 42 A.3d 261, 268 (Pa. 2012)).

The classification of a specific oil and gas lease as executory generally depends on:

- State law property rights.
- A determination of the interests conveyed under the particular agreement as interpreted under state law.
- The parties' ongoing obligations under the agreement.

Some courts applying state law have held that oil and gas leases are unexpired leases or executory contracts subject to section 365 reasoning that, under state law:

- The lease was a license or similar right to go on to the land to extract minerals from the ground which constitute personal property, not real property.
- The conveyance was a true leasehold interest.

(See *Frontier Energy, LLC v. Aurora Energy, Ltd. (In re Aurora Oil & Gas Corp.)*, 439 B.R. 674 (Bankr. W.D. Mich. 2010); *Texaco Inc. v. Louisiana Land and Exploration Co.*, 136 B.R. 658 (Bankr. M.D. La. 1992); *In re J.H. Land & Cattle Co.*, 8 B.R. 237 (Bankr. W.D. Okla. 1981)).

The US Bankruptcy Court for the Southern District of New York analyzed a debtor's midstream oil and gas gathering agreements in *In re Sabine Oil & Gas Corp.* and found that under Texas law the agreements did not convey an interest in real property (550 B.R. 59 (Bankr. S.D.N.Y. 2016)). The court ruled that the contracts are executory and can be rejected because the covenants at issue did not "run with the land" under Texas law. The court explained that the debtor did not, in the context of the relevant conveyance, reserve any interest for the contract counterparties, but instead engaged them to perform certain services related to the hydrocarbon products produced by the debtor's property. The court also found that the agreements did not explicitly grant the contract counterparties a real property interest in the debtor's mineral estate. The US District Court for the Southern District of New York later affirmed this decision (567 B.R. 869 (S.D.N.Y. 2017); see [Legal Update, In re Sabine: District Court Affirms Rejection of Oil & Gas Gathering Agreements as Executory Contracts](#)). The Second Circuit Court of Appeals affirmed the District Court's decision (734 Fed. Appx. 64 (2d Cir. 2018); see [Legal Update, In re Sabine: Second Circuit Upholds Rejection of Oil Gathering Contracts](#)).

After the *Sabine* decisions, the case law has been mixed. Some courts have adopted similar or even more expanded positions (see, *In re Extraction Oil & Gas, Inc.*, 622 B.R. 581, 585 (Bankr. D. Del. 2020) (applying Colorado law and finding that midstream agreements generally did not touch and concern the land and there was no privity

among the parties, therefore, no covenant ran with the land and agreements can be rejected); *In re Nine Point Energy Holdings Inc.*, 2021 WL 2212007 (Bankr. D. Del. June 1, 2021) (applying North Dakota Law); *In re Southland Royalty Co. LLC*, 623 B.R. 64 (Bankr. D. Del. 2020) (applying Wyoming law)).

In *Southland Royalty*, however, while the court determined that the midstream agreements did not create covenants running with the land, the court took the additional step of finding that the agreements were executory contracts subject to rejection if the midstream agreements had indeed created covenants running with the land (*Southland Royalty*, 623 B.R. at 88 ("Real covenants are contractual obligations, albeit exceptional forms that bind landowners regardless of their consent")).

Other courts have reached contrary positions based on the particular circumstances of those cases (for example, see *Monarch Midstream, LLC v. Badlands Prod. Co. (In re Badlands Energy, Inc.)*, 608 B.R. 854 (Bankr. D. Colo. 2019) (nondebtor party to gas gathering and processing and other agreements with debtor objected to its section 363 sale of Utah oil and gas assets free and clear of the agreements, arguing that dedications contained these agreements were covenants running with the land and the court agreed with objector, finding *Sabine* to be inapplicable because it involved application of Texas law and "a very different" dedication); *In re Alta Mesa Resources*, 613 B.R. 90 (Bankr. S.D. Tex. 2019) (gathering agreement constituted a covenant running with the land under Oklahoma law, not a contract subject to rejection under section 365)).

While *Badlands Energy* and *Alta Mesa Resources* do not outright reject the *Sabine* decision, they challenge and potentially limit its applicability. As more E&P debtors file for bankruptcy protection, depending on the facts of the case and applicable jurisdiction, some debtors may take aggressive positions regarding their midstream agreements to attempt to reject and extricate themselves from these agreements and some E&P companies may be incentivized to use the bankruptcy process for these purposes to preserve and reorganize their business, instead of other out-of-court alternatives.

These disputes potentially may lead to more litigation and, in some cases, debtors may obtain more negotiating leverage. The full import and effects of *Sabine* and other recent cases on this issue is likely to be fleshed out further by the courts. A debtor's ability to reject an out-of-market midstream agreement ultimately may largely depend on its chosen venue and the approach employed by that venue.

Other courts applying state law have held that a mineral interest lease is neither a lease nor an executory contract because under applicable state law the relevant instrument created a presently vested interest in real property that was intended to run with the land (see *In re Foothills Texas, Inc.*, 476 B.R. 143, 156 (Bankr. D. Del. 2012)).

Therefore, the transferor had no remaining material obligations and the real property interest cannot be impaired or modified in the bankruptcy (see *In re Topco, Inc.*, 894 F.2d 727, 739 n. 17 (5th Cir. 1990) (lease “constitute[d] a sale of part of the land”); *Terry Oilfield Supply Co., Inc. v. Am. Sec. Bank, N.A.*, 195 B.R. 66, 73 (S.D. Tex. 1996); *In re WRT Energy Corp.*, 202 B.R. 579 (Bankr. W.D. La. 1996)).

Some commentators remark that in most oil and gas producing states, an oil, gas, or mineral lease conveys a real property interest to the lessee and, therefore, the lease creates a presently vested interest in real property that is not subject to section 365 of the Bankruptcy Code.

In certain cases, the US government has taken the position that federal oil and gas leases are subject to section 365 of the Bankruptcy Code and can be rejected (see *NGP Capital Res. Co. v. ATP Oil & Gas Corp., Inc. (In re ATP Oil & Gas Corp., Inc.)*, Case No. 12-36187, Adv. No. 12-03443 (Bankr. S.D. Tex. 2012) (Docket No. 13)).

For example, the Department of Interior has reasoned that federal leases are governed by federal law and are subject to disposition under section 365 based on the language of the Outer Continental Shelf Lands Act, which details that outer continent shelf leases are “rental agreements to use real property”. In these situations, leases are subject to rejection, assumption, or other disposition under section 365, subject to cure, if the lease is assumed and all notice requirements must be followed.

Joint Operating Agreements

An E&P company’s joint operating agreement is typically an agreement that splits the working interests among multiple E&P companies either as operators or non-operators regarding oil and gas operations in certain specified lands.

Because exploration, development, production, or a combination of all may be ongoing on the properties at the time of the Chapter 11 filing, unperformed duties remain and the lack of performance of these duties constitute a material breach. Therefore, joint operating agreements likely fall within the ambit of section 365 of the Bankruptcy Code and are treated as executory.

Implications of Treating Agreements as Executory

The distressed investor must understand and thoroughly analyze the issue of whether an oil and gas lease is treated as an executory contract or a lease that can be assumed and rejected so that a proper risk profile can be assigned to the E&P investment.

Classifying an oil and gas agreement as either a lease or an executory contract within the scope of section 365 of the Bankruptcy Code requires consideration of:

- Whether the agreement may be assumed or rejected.
- The timing of assumption or rejection. If the agreement is a true lease of real property it must be assumed or rejected within a maximum 210-day time limit; if it is an executory contract, it must be assumed or rejected by plan confirmation.
- The necessity of curing prepetition defaults if the agreement is assumed by the debtor.
- The requirement to pay unsecured rejection claims if the agreement is rejected.
- The requirement of providing adequate assurance of future performance to the non-debtor party if the agreement is assumed.

Even if a particular oil and gas agreement may be rejected or assumed, the debtor and its stakeholders may not receive the results they desire. For example, some operating agreements may create contractual lien rights and those rights may be preserved despite the rejection of the operating agreement.

However, these liens are not binding on third parties unless certain steps are taken under applicable non-bankruptcy law, such as recording of the operating agreement or related memorandum. For joint operating agreements, the parties typically must perfect their interests by executing, acknowledging, and recording a memorandum of the operating agreement in the appropriate land records of the county or counties where the lands are located.

Preferences and Fraudulent Conveyances

Under section 548 of the Bankruptcy Code, certain transfers or conveyances made by the debtor up to two years before filing for bankruptcy and up to four years in states like Texas and Pennsylvania, can be avoided postpetition. Transaction avoidance often arises from either the debtor’s actual intent to hinder, delay, or defraud its creditors or from the failure to receive reasonably equivalent value in exchange for the

transferred interest at a time when it was or became, as a result of the transfer, insolvent.

Therefore, if an investor transacts with the debtor within four years of an E&P's bankruptcy, it may be subject to a fraudulent transfer clawback to recover the distributed proceeds or property if reasonably equivalent value was not received while the debtor was insolvent or if actual intent is proven.

Section 547 of the Bankruptcy Code similarly permits the avoidance of certain prepetition transfers of the debtor's property interests to creditors. Section 547 is designed to prevent the preferential treatment of some creditors over others during the period immediately before bankruptcy. However, unlike fraudulent transfer avoidance, the reach back period for preference payments is 90 days before filing for bankruptcy or one year if that transfer was made to an insider.

Investors must be mindful of bankruptcy risks concerning their sale and property interests as they may be subject to fraudulent transfer and preference actions.

Abandonment and Compliance with Non-Bankruptcy Laws and Regulations

A potentially significant concern in an E&P company's bankruptcy proceeding is the debtor's ability or inability to abandon unproductive or unnecessary oilfields and other facilities. Under federal and state laws, E&P companies must plug and abandon an oil well after drilling or production ceases. Under federal law, oil and gas companies operating offshore on the Outer Continental Shelf must plug and remove all structures on a lease within certain time periods after the end of production. Plugging and abandonment (P&A) claims are common in oil and gas bankruptcy cases and are often brought by state and federal authorities and co-liable parties.

Authority Permitting Abandonment

A debtor E&P company may try to abandon the well, site, or other facility under section 554 of the Bankruptcy Code as opposed to undertaking P&A measures. Some courts permit abandonment, regardless of non-bankruptcy environmental laws and regulations when there is no imminent or immediate identifiable threat posed to public health or safety (see *In re L.F. Jennings Oil Co.*, 4 F.3d 887, 890 (10th Cir. 1993); *In re Smith-Douglass, Inc.*, 856 F.2d 12, 16 (4th Cir. 1988); *In re Guterl Special Steel Corp.*, 316 B.R. 843 (Bankr. W.D. Pa. 2004); *In re Shore Co., Inc.*, 134

B.R. 572 (Bankr. E.D. Tex. 1991); *In re Exide Holdings, Inc.*, 2021 WL 3145612 (D. Del. July 26, 2021)), particularly, if the debtor lacks sufficient unencumbered funds to do the remediation itself (see *In re Better-Brite Plating*, 105 B.R. 912, 917 (Bankr. E.D. Wis. 1989), vacated on other grounds, 136 B.R. 526 (Bankr. E.D. Wis. 1990)).

In the *ATP Oil & Gas* bankruptcy, the bankruptcy court authorized the debtor to abandon an offshore platform and network of wells and gathering facilities, despite the properties having to be plugged and decommissioned at potential cost of \$100 million (see *In re ATP Oil & Gas Corp.*, 2013 WL 3157567 (Bankr. S.D. Tex. June 19, 2013)). To ensure public health and safety, the US took measures to remediate and, by agreement with the debtor, was permitted to retain an administrative claim for the decommissioning costs (see *Governmental Action*). Because it is often unlikely that an estate has sufficient resources to pay large administrative claim for remediation, the remediating party (often the US government) may choose to pursue other non-bankrupt related parties or predecessors-in-interest for some or all of the decommissioning costs (*In re ATP*, 2013 WL 3157567, at *2).

Authority Requiring Compliance

Despite those cases that permit abandonment, there is also substantial authority to the contrary generally requiring compliance with environmental obligations under applicable federal, state, and local laws and regulations (see *In re Appalachian Fuels, LLC*, 521 B.R. 779 (Bankr. E.D. Ky. 2014); *In re Am. Coastal Energy, Inc.*, 399 B.R. 805, 813 (Bankr. S.D. Tex. 2009); *In re H.L.S. Energy Co., Inc.*, 151 F.3d 434 (5th Cir. 1998)). These cases fall in line with the general requirement that Chapter 11 debtors continue to operate and manage their assets.

Depending on the circumstances of the particular oil well, site, or other facility, substantial or nearly substantial compliance with applicable non-bankruptcy environmental laws may be required to eliminate an imminent or immediate risk to public safety (see *In re Eagle-Picher Holdings, Inc.*, 345 B.R. 860 (Bankr. S.D. Ohio 2006); *Leavell v. Karnes*, 143 B.R. 212 (S.D. Ill. 1990)).

Governmental Action

As a practical matter, the debtor may lack sufficient resources or fail to properly either:

- Plug and abandon an oil well.
- Remediate the oil and gas facilities to address matters of public health and safety.

Distressed Investor Considerations in E&P Oil and Gas Restructurings

In that case, it is likely that another party, such as federal or state governmental authorities or other parties in the chain of title, undertakes these actions. Those parties, including the governmental agencies that take on the responsibility of plugging or remediating may assert administrative priority claims against the estate on account of these actions (see *Matter of H.L.S. Energy Co., Inc.*, 151 F.3d 434 (5th Cir. 1998); *In re Wall Tube & Metal Products, Inc.*, 831 F.2d 118, 122 (6th Cir. 1987); *In re Peerless Plating Co.*, 70 B.R. 943, 946-47 (Bankr. W.D. Mich. 1987)).

In addition to the operator, current owners, lessees, and their predecessors-in-title (regarding obligations accrued before the assignment of their interests) may be liable under applicable state and federal law (for example, see Tex. Nat. Res. §§ 89.012, 89.042 (“nonoperator”, that is, “a person who owns a working interest in a well at the time the well is required to be plugged” may be ordered to plug a well and is responsible for proportionate share of costs of proper plugging if operator fails to comply)).

Whether a particular P&A claim is entitled to administrative priority may depend on applicable non-bankruptcy law and when the liability arose (see *Leavell v. Karnes*, 143 B.R. 212; *In re Am. Coastal Energy, Inc.*, 399 B.R. 805; *In re ATP Oil & Gas Corp.*, 2014 WL 1047818 (Bankr. S.D. Tex. March 18, 2014)).

Governmental entities and contractual partners often require the posting of bonds and provision of other financial guarantees that can only be released after wells are plugged or after the operator posts a bond or other financial security.

Key Takeaways

While operational and financial turnarounds can help E&P companies, true relief comes from higher oil prices for sustained periods. However, oil prices remain volatile because numerous factors, including international political and economic developments, including the conflict between Russia and Ukraine and the strength or tepidity of China’s energy demands in the post-COVID-19 period, exert downward pressure on prices.

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In this continuing uncertain environment, as E&P companies file for or are thrust into bankruptcy, the substantial uncertainties and risks that arise (economic, financial, business, and legal) require investors to become familiar with the potential salient issues to protect their investments, including:

- The possible opportunity for lenders to provide consensual accommodations and implement other out-of-court alternatives (see Possible Accommodations).
- The difficulties associated with reserve-based facilities and potential consequent liquidity issues (see Reserve Based Financing).
- The substantial risk, in many cases, of creditors commencing an involuntary bankruptcy case (see Risks for Investors in Involuntary Bankruptcy Filing).
- The prospect of the investor’s E&P company prematurely filing a bankruptcy case (see Risks for Investors in a Premature Bankruptcy Filing).
- The potential challenges and difficulties for investors in a Chapter 11 case, including:
 - complying with the automatic stay concerning termination of E&P leases, recoupment, and setoff, all which affect the debtor’s assets and liabilities (see The Automatic Stay);
 - the risk of significant 503(b)(9) claims that consume significant estate value as administrative claims (see 503(b)(9) Claims);
 - the characterization and treatment of E&P leases and other contracts, depending on the relevant jurisdiction and the particular circumstances of the contract (see Executory Contract and Lease Rejection: Section 365); and
 - the risk of avoidance actions brought to recover prepetition transfers of the debtor’s property (see Preferences and Fraudulent Conveyances).
- The ability of the E&P company to abandon burdensome property and its obligations relating to its property, including potentially large administrative claims against the company (see Abandonment and Compliance with Non-Bankruptcy Laws and Regulations).

Given the current economic conditions and the short-term outlook for the oil and gas industry, there is likely to be continued distress and uncertainties in the industry that presents both opportunities and challenges for investors. A broad understanding of the potential risks and issues confronting E&P companies, together with advice from appropriate professionals, assists the investor during this phase.